Redstone Advisors

Economic and Market Review

Third Quarter 2013

"He that diggeth a pit shall fall into it."
Ecclesiastes 10:8

" The U.S. is nowhere close to sliding into a pernicious deflation."
Alan Greenspan, Former Chairman of Federal Reserve Board, December 19, 2002

"Well Jane, it just goes to show you, it's always something. If it ain't one thing, it's another. If it ain't a taper, it's a government shutdown." With apologies to Roseanne Roseannadanna, when it comes to attributing causality within the realm of political economy, the *shills* and the *barkers* which are the main stream media, would have us believe that the only *causes* that should inform our discourse are those presumed to immediately impinge on an event or result, i.e., "proximate" causes. Yet what was billed only last month as the singularly most important cause acting upon the markets, namely the impending "taper" of the Fed's QE program, quickly gave way to the next *singularly most important cause*, the government shutdown and debt ceiling. With the temporary and shameful resolution of the shutdown, causality will no doubt now shift to the tepid third quarter earnings, the crisis in Europe, or even a repeat fixation on the "taper". Such superficiality advanced as causality may be sufficient for speculative operations in the new robo-trading world dominated by algorithms and high frequency trading, but it is wholly insufficient for investment operations grounded on a proposition of wealth preservation. Such operations demand that we reason from *universals to particulars* and as such, concern ourselves with "remote" or ultimate causes. This we have done. For as our long-time readers know, we have been nothing if we have not been consistent. (Some would say monotonous) One benefit of that consistency is the portability of our prose. Writing in January of 2003 in a newsletter entitled "The Sum of All Fears", we said;

> The prospects for deflation, like those for a nuclear war with Russia, are infinitesimally small, according to the high priests of the Federal Reserve. Over the course of the last eight weeks, Chairman Greenspan and Governor Bernanke (the new guy), have gone out of their way in speeches and prepared remarks to assure us that all concerns regarding the dreaded d-word are both unfounded and irrational. . . . . . According to Messers Greenspan and Bernanke, this country has not seen a “pernicious deflation” since the 1930s. And according to Fed lore, it is, as Tolkien would say, “a foe long vanquished ere this age of the world began”. For ourselves, we prefer to lift a quote from Tom Clancy’s book of the same name as this newsletter; “The [deflation] bomb is in play”.

It was the Nobel prize winning author Andre Gide who poignantly observed; *"Everything has been said before, but since nobody listens, we have to keep going back and beginning all over again."* Alright, let's begin again at the beginning. Having finally reached the zero-boundary in their fight against deflation, central planners of all stripes are printing money, buying assets and manipulating markets for just one reason: they are paralyzed by the fear of what might happen if they don't. We now repeat our "agitators" warning of 10 years ago; **The pit has been dug and the deflation bomb is *still* in play!**

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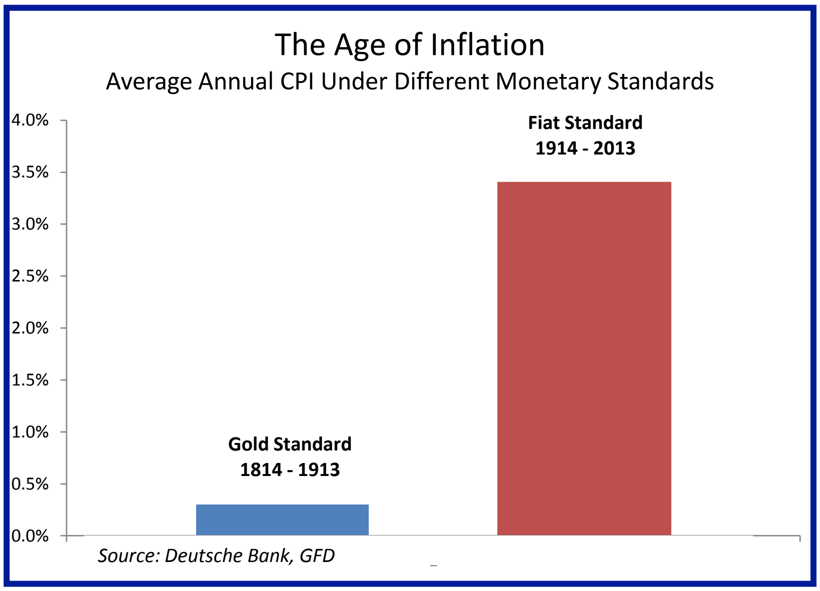
Deflation is still *the* fact that threatens global markets, and by extension the banking cartel, with a systemic risk of collapse and therefore informs all policy decisions and impacts all market movements. The most recent Fed *non-taper* decision establishes this fact beyond any reasonable doubt. After having spent four months jawboning markets on an impending reduction in its' quantitative easing program, replete with projected dates and amounts, the results of which were a sharp rise in interest rates, a marked deceleration in speculative housing activity and a nascent crisis in emerging markets, yet come T-Day, the much awaited statement by the stabilizers amounts to a *"never mind"*? Notwithstanding Fed President Bullard's *post hoc* explanation that the *nonexistent-as-of-the-September-Fed-meeting*, government shutdown *"changed the odds"* of the taper decision, the stunning *"yes we have no-taper today"* decision by the stabilizers revealed a complete absence of an endgame plan. The stabilizers understand clearly that any downtick in the economy could cause us to fall into the dreaded pit of debt deflation. The instability and fragility of both the markets and the economy are such, that they cannot withstand even the impact of a random snowflake. Hence the stabilizers credo, born of Paul Valéry's admonition that *"there is nothing more constant than the unforeseen"*, that *all weather must be controlled*.

We have for years, never tired of telling the "old, old story" of the decline of honest money, the ascendancy of the State and the resultant diminution of liberty and the distortion of markets. In a phrase, the story of the *monetary sin of the west*. This period encompassing the last 100 or so years, has been, to lift the title of Jacques Rueff's book, **'The Age of Inflation' (Figure 1)**. But inflation, particularly the insidious kind that through a continuous process of money production and currency debasement, allows governments to confiscate and transfer, secretly and unobserved, an significant part of the wealth of their citizens from the *trivial many* to the *vital few*, is but the forerunner to deflation. For to disabuse Say's Law of the Markets, ***"demand creates its' own deflation."*** Just as the bust follows the boom, sooner or later -- perhaps much later if the debauched currency enjoys the *exorbitant privilege* of being a **reserve currency** -- but inevitably nonetheless, the age of inflation gives way to a deflationary dark age *a la* US circa 1930s or present day Japan. That this has been, and is so, we have, like the voice of one crying in the wilderness, attempted to proclaim. By dissertation, by polemic, by metaphor, and by the parsing of history, we have endeavored to sound the alarm. To recast Scripture; *"Knowing the terror of* [deflation], *we persuade men."*

Figure 1



But you will say, *"ten-years ago when you rang the alarm regarding deflation, then Chairman Greenspan summarily dismissed the possibility of a 'pernicious deflation' as pure twaddle and tommyrot. And to date, we have not experienced a debilitating debt deflation."* Writing in his book 'Debt and Delusion', Peter Warburton penned an appropriate rejoinder. *"There is an interval of time between cause and effect which can sometimes be so short as to deem worthless an understanding of the process connecting them. Knowing that the pulling of a trigger precedes the release of a bullet provides scant opportunity to take evasive action. In the case of the consequences of an over-accumulation of debt, the opposite problem presents itself. Sometimes the interval between cause and effect appears to be so long as to separate them by oceans of doubt."*

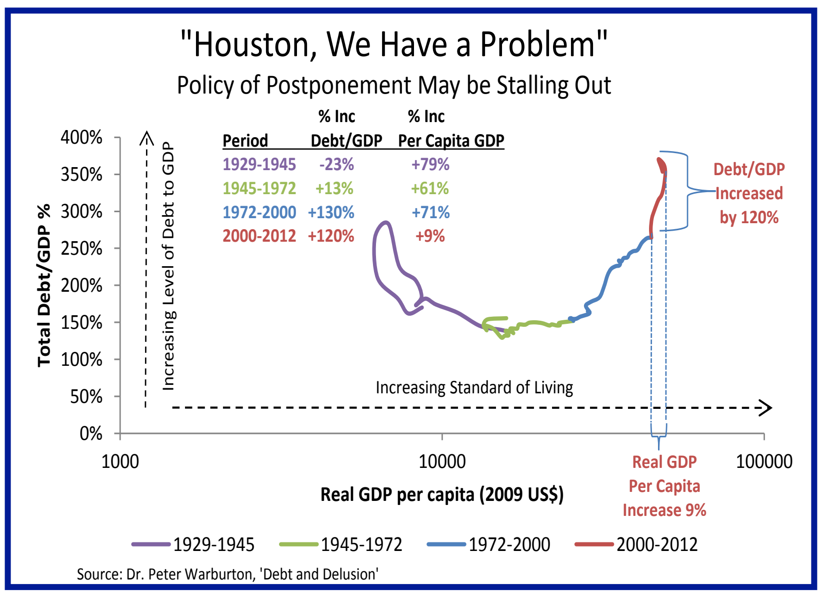
It has been during this prolonged interval of doubt that we have been sounding the alarm and during that time our long-standing contention has been and remains that, not unlike the Parousia, all the preconditions for a debt deflation have been met and the west is effectively living on borrowed time. However, we have always insisted that this would be a *process, not an event*. Debt has many forms, both nominal and derivative, measureable and immeasurable, and only when all conceivable means of postponement have been exhausted will the party finally be over. So debilitating is the outcome that awaits us on our present course, so deep the pit, that every ounce of human ingenuity, born of self-interest, will be developed and arrayed against it in an effort to forestall its' appearance. Nevertheless the forces of financial disintegration are becoming harder to dispel, despite the fact that the stabilizers are fully committed to the task of doing *whatever it takes*. And while by central bank decree, debilitating deflations and Great Depressions were supposed to have been repealed, we would invite you to consider the increasing number and magnitude of the crises that have erupted over the past 15-plus years. The 1994 Mexican Debt Crisis, the 1997 Asian Currency Crisis, the 1998 Russian Financial Crisis and collapse of Long Term Capital Management, the Dot-Com bubble of 2000, the housing bubble of 2007, and the Great Recession of 2008 replete with an ongoing European sovereign debt crisis. You may recall that it was 'Easy Al', the Maestro himself, who schooled us on bubble-blowing when he said; *"a bubble in and of itself doesn't give you a crisis."* Perhaps it is time for the central planners to join hands with Chief Inspector Dreyfus and engage in a little autosuggestion; *"Every day, in every way, I'm getting better and better. Every day, in every way . . . ."*

But is the perpetual postponement of that, which while painful in the short-run, is nevertheless absolutely essential for long-term survival, really improvement? Certainly to a hedonist the avoidance of any pain at any cost would be considered a goal worthy of doing, "whatever it takes." It was the Austrian economist F.A. Hayek who, in his book 'The Fatal Conceit' observed; *"We cannot make moral decisions simply by considering the greatest forseeable gratification."* As we have stated on previous occasions, the act of choosing by self-interested human beings necessarily involves moral implications. Therefore one of the primary goals of the science of human choice, i.e., economics, is to evaluate not simply the utility, but also the fitness of the means chosen to achieve a particular end. We have for many years agitated against both the disutility as well as the injustice of the continuing policy of postponement through intervention and monetary inflation, the results of which have been the continuing and increasing degree of disorder in both the financial markets as well as the economy. The massive increase in the production of money is not only futile, but it is in fact exacerbating the crisis by preventing market prices from adjusting to market clearing levels and liquidating malinvestments, whereby capital would be permitted to be redirected from unprofitable and uneconomic pursuits through Schumpter's process of creative destruction. For this reason we continue to insist, ***the solution*** [digging] ***remains the problem***.

The current economic malaise facing both the US and most western developed economies, which we have characterized as a ***rolling recession*** consisting of persistent below-potential economic growth, intractable unemployment, exponential growth in unproductive debt, chronic sovereign deficits, and a massive famine of income, is **structural** not cyclical. It represents the distortive impact of the culmination of over 40 years of increasing intervention and monetary inflation, of deepening the pit through a policy of postponement. During this period, the US economy has been transformed from a market economy to a mixed economy. And while a mixed economy does create wealth, it does so, not by virtue of autonomously rewarding individual achievement, but through a system of privilege and restraint, under which the *planners* pick "winners", and by non-selection, "losers", thus conferring an unjust advantage on one party over another. The result of which is an economy whose wealth creation is limited and whose wealth distribution is skewed in favor of the *vital few* over the *trivial many* (Pareto). However the forced transfer of wealth will always result in the loss of a portion of the wealth in the transfer. *"Owing to the Law of Providence,"* says Bastiat, *"a moment comes when the destruction of wealth is such, that the despoiler is poorer than he would have been if he had remained honest."*

It is precisely that "moment" against which the stabilizers are exerting every effort, foul or fair, to postpone. However, the fallacy of focusing solely on the short-run benefit of the avoidance of a correction as against the long-run sustainability of a policy of perpetual inflationism, may be illustrated in **Figure 2**. This chart, which we have presented on previous occasions, is a reproduction of a chart originally found in Dr. Peter Warburton's book, 'Debt and Delusion'. This chart is somewhat complicated and requires careful interpretation. The vertical axis measures the ratio of the total stock of debt in the US economy as a percentage of GDP. A rising line indicates an increase in the debt to GDP ratio. The horizontal axis is a logarithmic scale of real US GDP per capita and is a proxy for the standard of living in the US. A line which moves left to right indicates a rising standard of living while a line that moves right to left indicates a declining standard of living. The evolution of these two variables is reflected in the resulting wiggly line. The annual data covers the period from 1929 through 2012, with the data broken down into four time intervals, each represented by a different color line segment. And while the data points are presented in chronological order, there is nothing to prevent a line segment from folding back on itself, indicating a retrograde movement in per capita income associated with a deflationary decline in debt.

Figure 2

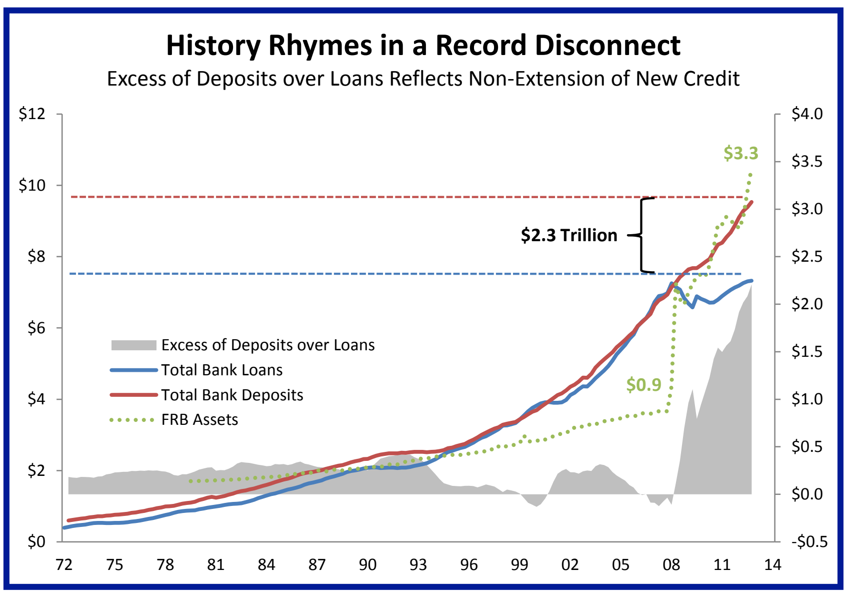


The interpretation of the chart is as follows. When the line moves horizontally from left to right as it did during the Bretton Woods era of 1945 to 1972 (green line), the standard of living was rising in the context of a stable debt multiplier. When the line moves from bottom-left to top-right as it did between 1972 and 2000 with the inauguration of the paper money era (blue line), a rise in the standard of living was accompanied by an expanding debt multiplier, suggesting that despite a sharp rise in indebtedness, much of the debt put in place was marginally productive. And while both scenarios saw a rise in the standard of living, clearly the Bretton Woods era of stable debt represents the more ideal arrangement. In the extreme situation of a **sharply rising vertical line** such as has been occurring since 2000, **debt is expanding exponentially without delivering any discernable short run benefit to real per capita income** or economic expansion. In fact, since 2009, the line has begun to loop over on itself in a retrograde action, indicative of a debt deflation not unlike that which occurred in the period from 1929 to 1945 when the credit system broke down and living standards collapsed. As such, **Figure 2** strongly suggests we are now in a period of diminishing marginal returns for money production whereby each additional dollar of fiat credit put in place results in an ever diminishing return in the form of economic activity. This, in our opinion, offers corroborating evidence of an impending deflationary **famine of income** resulting from the continuous application of a short-run stimulus over a long-running period of time. And while we would certainly agree with Mr. Keynes that in the long run we are all dead, it is nevertheless equally true that we can be just as sincerely dead in the short-run when in time, the short-run becomes the long-run. To quote Einstein; *"The only reason for time is so that everything doesn't happen at once."*

So while it is true that to date, we have not fallen headlong into a deflationary pit, it is equally true that we have not stopped digging. Far from it, for lacking the requisite political will to make the hard choices, as most recently evinced by the disgraceful behavior of our government and its' inability to reign in our profligate spending, we have, through the policy of postponement, merely redoubled our efforts at deepening the abyss. Writing in his book 'When Money Dies: The Nightmare of the Weimar Collapse', author Adam Fergusson addressed both the futility and the immorality of deferment as the policy of choice: *"The take-off point in the inflationary progress, after which the advent of hyperinflation was but a matter of time, the point indeed when it became self-generating and politically irreducible except for short periods, was not indeed to be found on the graph of the currency depreciation, or of the velocity of its circulation, or of the balance of payments deficit. What really broke Germany was the constant* ***taking of the soft political option in respect of money****. Day by day through 1920, 1921 and 1922, the reckoning was postponed, the more readily as the prospective consequences of inflation became more frightening. The take-off point therefore was not a financial but a moral one."* Truly, as philosopher David Hume observed, ***"The rules of morality are not the conclusions of our reason."***

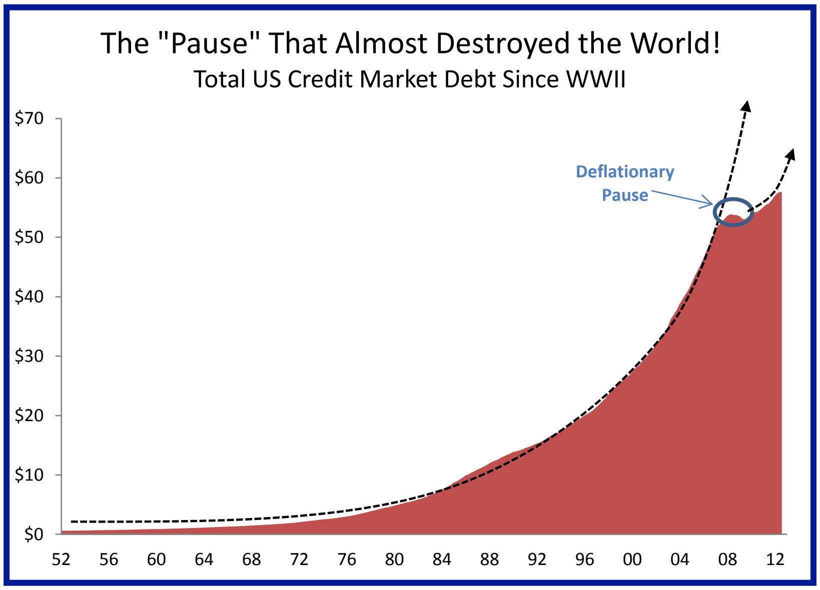
In the fullness of time, the credit inflation of the 1920s became the credit deflation of the 1930s. The volume of money and credit was reduced relative to the supply of goods due to bank failures, bankruptcies and the abstention of additional credit as the malivestments of the monetary boom were liquidated. It is, however, important to understand that it was the **non-extension of new credit** that played the critical role in initiating the onset of the crisis. It is the nature of the beast that a credit bubble requires an ever increasing volume of new credit to maintain the desired rate of increase in asset prices. The onset of the deflationary crisis is almost always tied to the reduction in the rate of increase in the volume of new credit, not an outright reduction in the outstanding level of credit. Referring to **Figure 3**, we can see that Twain was right, for while *history may not repeat itself, it does rhyme,* as it was the **non-extension of new credit** that played a pivotal role in the development of the *deflationary pause that nearly destroyed the world.* (Figure 4) This decrease in the volume of new credit is reflected in **Figure 3** by the massive gap which has developed between bank deposits and bank loans. Generally speaking, through the "magic" of fractional reserve banking, banks engage in money creation through the activity of lending. Lending begets deposits which beget more loans which become deposits in a kind of *virtuous circle.* This relationship is reflected by the fact that over time, total deposits and total loans exhibit a high degree of correlation. However, looking at **Figure 3** we can clearly see that beginning in 2008, there was a **record disconnect** between the growth in bank deposits and the growth in bank loans, with loan creation falling precipitously from September 2008 through early 2010, before recovering to their pre-Lehman level. As such there has been **zero loan growth** since the September 2008 collapse of Lehman, a period of nearly five years. During the same time, total deposits have continued to grow at their rapid pre-crisis pace, resulting in a gap of approximately **$2.3 trillion** of excess deposits over loans. Not coincidentally, this is also the same amount of reserves injected by the Fed into the banking system through the expansion of their balance sheet.

Figure 3



As discussed last quarter, in an all out effort to avoid the deflationary pit post-Lehman, the stabilizers have been the primary source of money creation, with most of it ending up in the financial markets through the labyrinth of hypothecation pathways within the shadow banking system. However, as the **"London Whale"** scandal at JP Morgan reminds us, this intermediation pathway is infinitely more hazardous than bank loans as this money production is free to flow to the most risky leveraged carry trade, increasing both the gearing and the instability of the economy and markets. And as the **"pause"** in the creation of debt and the consequent near catastrophic collapse poignantly reminds us **(Figure 4)**, we are far closer to the precipice of a *pernicious deflation* than the stabilizers would have us believe. Our **'fatal conceit'** has been to equate debt with money and therefore the production of debt with the production of wealth. For as a *particular debt* must be repaid -- or so it was once commonly held -- the extinguishment of a debt instrument that has been monetized, absent the incurrence and monetization of new debt to offset it, may, under our fiat currency system, initiate a deflationary contraction and threaten potential economic Armageddon. That the only "hedonic" policy option open to the stabilizers is to continue to *"kick the can down the road"* by supplanting the banking cartel in the creation of credit, has been the basis of our contention that *Atlas will not shrug*. That monetary inflationism is the *sine qua non* of the stabilizers policy of postponement is beyond debate. What they have achieved, on the other hand, is a matter capable of question. Weighing in with his conclusion, and writing in his book 'Human Action', Austrian economist Ludwig von Mises was not optimistic; *"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system."*

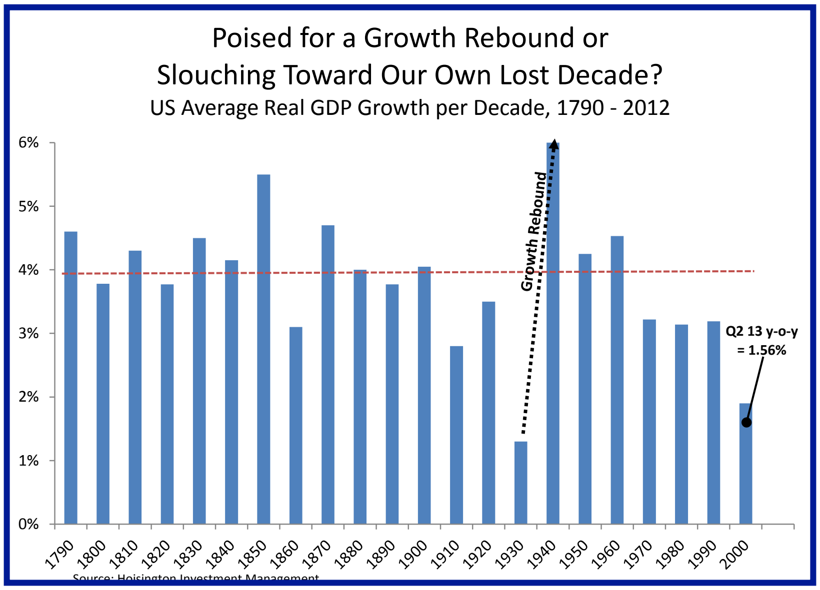
Figure 4



We have long chronicled the macro-economic impact of the ever-increasing dependence of the US economy on the perpetual production of money, a phenomenon we have dubbed the **"financialization of the economy."** We have insisted that the long-run macro-economic outcome of the stabilizers preferred policy of postponement through the continual production of money would be economic stagnation manifesting itself in historically high and intractable unemployment, stagnant to declining real incomes, and a **"rolling recession."** By increasing the money claims against existing wealth without a commensurate increase in the means of production through real savings, the economy is continually impoverished due to the destruction of wealth through increased consumption, speculation, malinvestments and the diversion of wealth in the form of debt service to the holders of the new fiat money. On previous occasions, we have highlighted the recent experience of Japan as illustrative of this form of **economic sclerosis** by pointing out the unprecedented downshift in Japan's GDP **trend growth** since the deflationary collapse of their housing bubble in 1990 and the start of their unprecedented experiment with money printing. In particular we noted that since 1990, economic growth in Japan as measured by GDP growth, has all but stagnated, providing us with a real-time illustration of a **20-plus year rolling recession**. The present economic "expansion" in the US reveals an eerily similar picture. Referring to **Figure 5** which is a reproduction of a chart produced by Hoisington Investment Management, we can see that a review of average growth rates in real GDP by decade from 1790 to

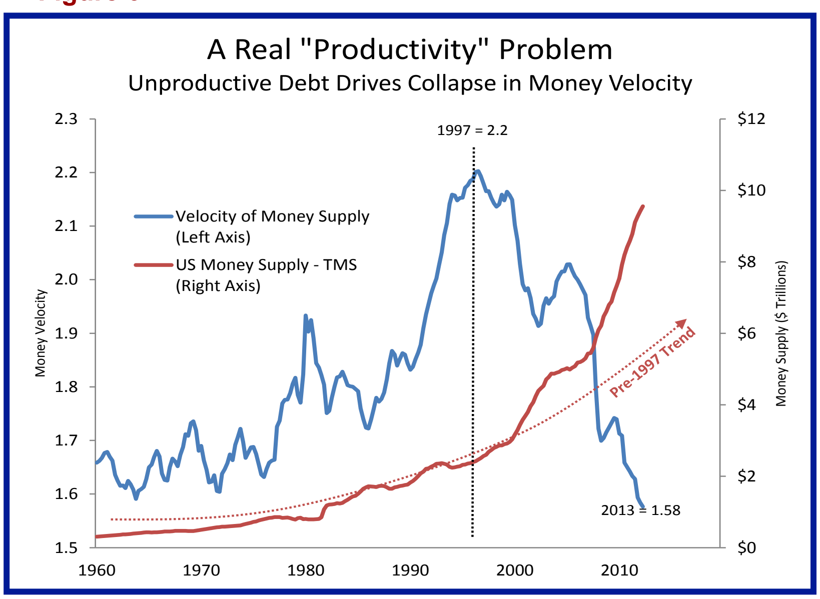
2012, puts the anemic US economic growth of the first 13-years of this century into stark relief. At **1.8 percent**, the growth rate is less than one-half that of the average growth rate of **3.8 percent** since 1790, and substantially below all post-WWII periods. The only decade which recorded a slower growth rate was, of course, the deflationary 1930s. And while the planners assure us that a period of rebounding economic growth is *just around the corner*, the most recent year-over-year growth rate of just **1.6%**, suggests we may instead be slouching toward our own lost decade(s). For reasons outlined in previous commentaries, we believe this impairment in economic growth to be secular in nature, the outgrowth of decades of monetary inflation combined with substantial secular headwinds including demographics, declining innovation, globalization, and rising income inequality. This, we suggest, is the real price of the central planners' **successful failure**.

Figure 5



The marked deceleration in economic growth, reflects Austrian economist Eugen von Böhm-Bawerk's insight that ***"debt is future consumption denied."*** Since as constructed, 70 percent of US GDP is **"consumption"**, the trend of declining GDP reflects, in part, the **"dead hand"** of non-productive debt upon consumption. It was Hyman Minsky who delineated "good" or productive debt from "bad" or non-productive debt by the existence of an income stream available to repay principal and interest on the debt. The "Ponzi" borrower who engages in non-productive debt, borrows on the hope that the appreciation in the value of the asset will be sufficient to refinance the debt as he cannot service the debt from the underlying cash flow. Critically then, it is rising asset values that can keep the Ponzi borrower afloat. This helps to explain the stabilizers preoccupation with levitating asset prices, particularly those of stocks, as most of the extraordinary liquidity created by the Fed has found its way into financial speculation. Referring to Figure 6, we can see this **"productivity problem"** reflected in a sharply declining money velocity, a measurement of the marginal productivity of an additional dollar of money (debt). As we can see, velocity peaked in 1997, suggesting the supply of market debt was approaching the non-productive zone. Coupled with the decline in velocity, has been an **exponential increase** in the money supply as the stabilizers,

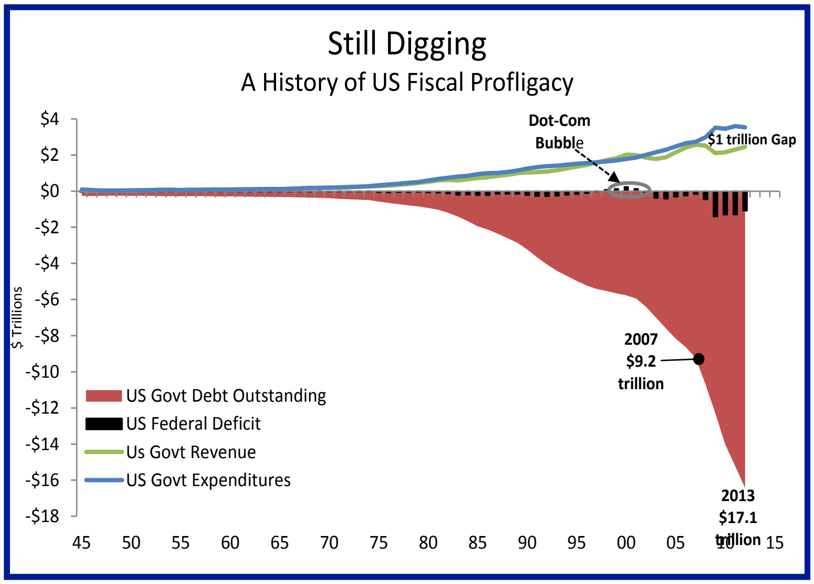
Figure 6



armed only with a flawed printing press policy, responded to in-kind to the serial crises listed earlier. The current impotency of this extraordinary intervention is due to years of monetary inflation and the accumulation of a massive level of non-productive debt associated with an expanding volume of malinvestments.

Much of that non-productive debt of late, is attributable to our deteriorating fiscal condition. As stated on previous occasions, despite public perceptions to the contrary, US fiscal deficits are structural, not cyclical. By this we mean that they are the result of the government consistently spending more than it takes in and as such, the deficit remains regardless of the economy's position in the economic cycle. Referring to Figure 7, we can see that, with the exception of the four year period between 1998 and 2001, the US has been consistently running a fiscal deficit since the late 1960s. (The four surplus years were attributable solely to the enormous capital gains tax harvested from the Dot-Com Bubble) The long-term accumulation of those deficits is reflected by the colossal growth of the US government "debt pit", and in particular the nearly **$8 trillion** increase since 2007, representing a near-doubling of government debt outstanding in just over five years. Coupled with an annual "excavation" of $1 trillion-plus deficits for as far as the eye can see, we are literally "digging a hole to China." (pun intended) While we do not pretend to know just what an unsustainable trend is, we are familiar with the solution as proffered by no less an authority than Will Rogers; ***"When you find yourself in a hole, quit digging."***

Figure 7

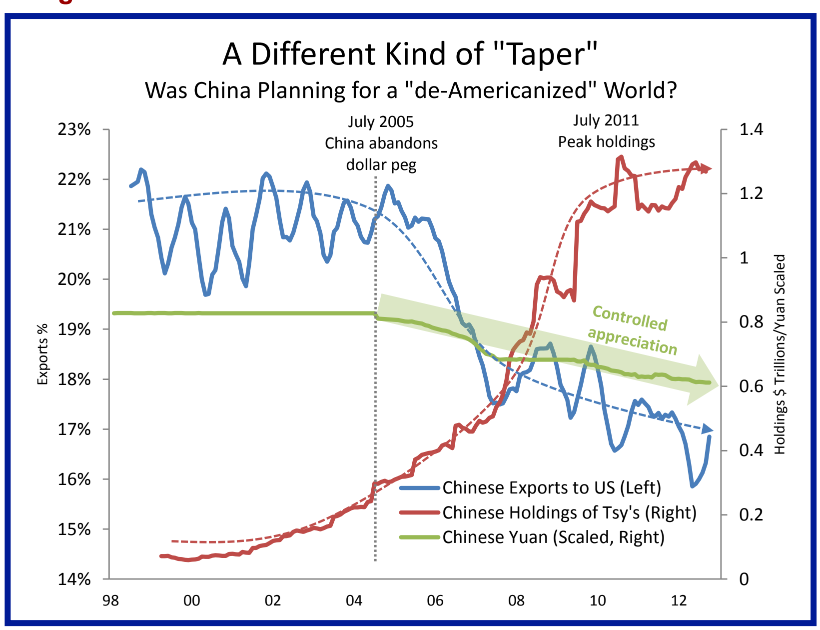


Ultimately, the cessation of the arguably unsustainable growth trend in US government debt is yoked to the fate of the dollar. As Mises suggested earlier, no less than the fate of the *global currency system* is at stake. Part of the *mystery* as to the extended period of time that continues to flow between the *cause* and *effect* of a potential deflationary accident, is bound up with our ***exorbitant privilege*** of issuing the world's international reserve currency. While the term exorbitant privilege was originally coined in the 1960s by Valéry Giscard d'Estaing, then the French Minister of Finance, it was defined by French economist Jacques Rueff. *"Under the protection of monetary inconvertibility,"*, wrote Rueff, *"the printing press can meet all market solicitations, with practically no limitations."* Rueff disparaged America's privilege to ***"run deficits without tears"*** because the US budget deficit and balance-of-payments deficits were -- and still are -- automatically financed by the Federal Reserve and the reserve-currency system through the voluntary (or coerced) buildup of dollar balances in the official reserves of foreign governments. *"In this way"*, Rueff said, *"any country in possession of this privilege is permitted to give without taking, lend without borrowing, and acquire without paying."* The elimination of convertibility under the gold standard gives the emitting nations' policy of inflation a *fig leaf* of propriety by masquerading as a procedure for the settlement of international liabilities, thus disguising a credit expansion as capital flows. In 1961, Rueff boldly predicted the elimination of dollar convertibility into gold and the collapse of the Bretton Woods system under the weight of the flood of US dollars flowing abroad. Ten years later, on August 15, 1971, Rueff was vindicated as President Nixon ended dollar convertibility and closed the gold window, thus defaulting on our obligation to redeem dollars for gold and more importantly, for the first time in history, the world was set adrift on a sea of floating non-convertible paper currencies. Out of the chaos of calculation which ensued during the rampant inflation of the 1970s and early 80s, the dollar emerged once again as the "best looking horse at the glue factory", establishing the dollar as the paper of choice. Nevertheless, writing in 1971, Rueff again warned; *"It is clear that the dollar standard is vulnerable because its outcome is a huge accumulation of dollar balances."*

Writing in his book 'The Blue Wound', author Garet Garrettson spoke metaphorically about this vulnerability; *"A city is like a giant hanging by its umbilical cord. Its belly is outside of itself, at a distance, in the keeping of others. Cut it off from its belly and it surrenders or dies. As the first city was so the last one is. No city endures."* What is true of cities is true of nations and even empires. We have written extensively in the past on the **"Faustian bargain"** between the **exorbitant-privilege-wielding** US and the **mercantilistically-minded** developing and emerging economies of Asia, and in particular China. (See for example, our February 2006 Newsletter entitled 'A Tragedy of the Commons') That the cumulative US trade deficits and China's mountain of foreign exchange reserves are simply two sides of the same coin should be beyond dispute. Under the current fiat dollar currency system, they are effectively an accounting identity. The US can continue to run large current account deficits and amass a burgeoning net external debt, we are told, because China and the developing economies of Asia are happy to accumulate dollars to preserve their trade advantage in the largest consumer market on the planet. And despite all denials, the beggar-thy-neighbor currency depreciations of today are, like the game of hot potato, designed to transfer unemployment to one's neighbor and increase one's market share in manufactured, labor-intensive, value-added world trade. This is mercantilism 101 and is, by the way, only possible because the US reneged on its promise to exchange dollars for gold. Had the US kept the dollar as "good as gold" by living within its means and maintaining convertibility, our welfare would not be *in the keeping of others* and neither China nor any nation could now threaten us with the repatriation of our debt.

Be that as it may, the **"Jacob and Esau"** trade between China and the US has, to date, served China quite well. After all, if a weak currency and a fetish for dollars can guarantee a 15-plus percent growth rate for China's economy, surely any potential costs associated with China's pile of dollars would pale in comparison to the output gains from a stronger economy and the avoidance of social unrest. While that reasoning may have seemed unassailable five or ten years ago, today it fails to comprehend the sheer scale of the problems China is now facing. At over $3.7 trillion, China's mountain of reserves amount to a staggering 46 percent of their GDP. And while China goes to great lengths to disguise the composition of their reserves, at least $1.2 trillion of those reserves are held in US Treasury securities. That is not an insignificant sum, even for China. On top of that, China's official reserve accumulation is being augmented by inflows of speculative capital, or so-called **"hot money"**. Much of the massive influx of hot money has not been fully sterilized, resulting in rapid growth in China's money supply, which in turn has fostered a domestic credit boom replete with a massive pile of bad loans, a spectacular real estate bubble and overinvestment in export sectors. To counteract these risks to its domestic economy and financial markets, we believe that China embarked on a long-term program to wean itself from its' overdependence on dollars several years ago. Referring to **Figure 8**, we can see in July of 2005, China announced the end of its long-running "peg" to the dollar. Instead they choose to align the value of their currency (renmimbi) with a "basket'' of

Figure 8



currencies and commodities, the composition of which was not disclosed. In 2007 they created the China Investment Corporation (CIC), a sovereign wealth fund, with an initial capitalization of $200 billion and a charge to diversify their reserve holdings. Today the CIC is nearly $600 billion, with a diversified investment portfolio including direct investments around the globe in energy, telecommunications and commodity industries as well as stocks, bonds and alternative assets. Referring again to **Figure 8**, we can see that since that time, China has embarked on a **"taper"** of their own with a controlled appreciation of their currency corresponding to both a gradual reduction in exports to the US and a slowdown in accumulation of US Treasury debt. In fact Chinese holdings of US Treasury's peaked at $1.3 trillion in July of 2011, immediately prior to the first debt ceiling crisis and ratings downgrade of August 2011. At the heart of China's dollar dilemma lies the classic cartel risk. Among those Asian countries benefiting from the dollars-for-goods trade, China and its currency occupies the key role. All other Asian countries must intervene on behalf of their own currencies to maintain their competitiveness vis-a-vis China. However, the continuing presence of large and growing US fiscal and trade deficits strongly suggests a large future devaluation is in order for the dollar and the longer countries stay in the cartel and provide vendor financing to the US, the larger the potential losses on their dollar hordes might be. So while it may be in the collective interests of all Asian central banks to hold dollars in order to keep their currencies down and the dollar up, it is in each of their individual interests to get out before the bottom falls out of the US dollar. And history shows, that just as it has happened with OPEC and the original Bretton Woods cartel, most cartels collapse because the incentive to cheat eventually proves irresistible. Recent unilateral currency agreements with other nations and official calls for a **"de-Americanized world"**, coupled with their farsighted planning suggests China may be preparing for such an eventuality. Ultimately the hegemony of the dollar may turn out to be the "Achilles Heel" of the US. Writing over 60-years ago in his book 'Economics in One Lesson', Henry Hazlitt said; *"There are men regarded today as brilliant economists, who deprecate saving and recommend squandering on a national scale as the way of economic salvation; and when anyone points to what the consequences of these policies will be in the long run, they reply flippantly, as might the prodigal son of a warning father: "In the long run we are all dead." And such shallow wisecracks pass as devastating epigrams and the ripest wisdom."*

Well, returning to that space of years that has elapsed since we first raised the alarm on a deflationary accident, it would appear that only the time has passed, the danger has not. Recalling Augustine's reproach of Rome; *"You have missed the profit of your calamity; you have been made most wretched, and have remained most profligate."* When might such a deflationary accident happen? While we believe that all conditions have been met, we have nevertheless, long advocated that this would be a process wherein the power of self-interest will keep the system in place far longer than would seem probable. Therefore regarding timing, we must resist the temptation to a pretence of knowledge. How then should we invest? We continue to recommend that investors *shelter in place* in high quality intermediate duration bonds with gold as hedge to maintain the purchasing power of the portfolio. Quoting Benjamin Graham; *"The essence of investment management is the management of risks not the management of returns."* Having opened with a quote from the 'Preacher' regarding the consequences of digging pits, we close with an admonition from the book of the Law on loitering around pits; *"Their foot shall slide in due time. For the day of their calamity is at hand, and the things to come hasten upon them."* Deut 32:35.